

ORIGINAL



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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION  
DOCUMENT CONTROL

IN THE MATTER OF THE APPLICATION OF  
ARIZONA WATER COMPANY, AN ARIZONA  
CORPORATION, FOR ADJUSTMENTS TO  
ITS RATES AND CHARGES FOR UTILITY  
SERVICE FURNISHED BY ITS WESTERN  
GROUP AND FOR CERTAIN RELATED  
APPROVALS.

Docket No. W-01445A-04-0650

RUCO'S INITIAL CLOSING BRIEF

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits the following points in support of its position in the Arizona Water Company's ("Company or Arizona Water") rate application. RUCO recommends that the Arizona Corporation Commission ("Commission") approve a total revenue increase of no more than \$110,229<sup>1</sup> for the Company's Western Group. RUCO further requests that the Commission adopt its recommendations regarding the following:

<sup>1</sup> This figure represents RUCO's revised increase in gross revenue for the entire Western Group. This revision reflects the elimination of RUCO Rate Base Adjustment Numbers 1 through 4 (on accumulated depreciation amounts) for all five Western Group systems, the reduction of RUCO's Rate Base Adjustment Number 7 for Casa Grande Legal Expenses from \$824,374 to \$767,454, and RUCO's corrected adjustment for APS purchased power (RUCO Operating Adjustment Number 4) for all five Western Group systems. See attached Exhibit 1.

- 1           1)       Rate Base – RUCO recommends the Commission deny the Company's  
2                   request for \$767,454 in capitalized legal expenses related to the Company's  
3                   litigation with the City of Casa Grande. RUCO recommends the Commission  
4                   deny the Company recovery of deferred CAP charges associated with the  
5                   Western Group systems. Finally, RUCO recommends the Commission deny  
6                   the Company's requested level of cash working capital.
- 7           2)       Operating Income – RUCO recommends the Commission adopt its test-year  
8                   revenue and expense annualization based on the level of customer growth for  
9                   the entire test-year. RUCO also recommends the Commission adopt its  
10                  adjustment for purchased power expense and property tax expense based on  
11                  the formula used by the Arizona Department of Revenue ("ADOR").
- 12          3)       Purchased Water and Purchase Power Adjustment Mechanisms – RUCO  
13                   recommends that the Commission deny the Company's request for the  
14                   continuation of automatic adjustors for purchased water and purchased power.
- 15          4)       Rate Design - RUCO recommends the Commission adopt its proposed three-  
16                   tier inverted block structure.

17           Finally, RUCO recommends the Commission adopt its recommended 9.17% weighted  
18   average cost of capital.

1 **RATE BASE**

2  
3 **1) LITIGATION EXPENSES**

4 The Company has requested the inclusion of \$767,454 in its ratebase for legal  
5 expenses regarding its litigation with the City of Casa Grande ("City"). A-21<sup>2</sup> The litigation  
6 dates back to 1999, and centers on the issue of the City's right to sell its effluent water to the  
7 Company's customers in the Company's service territory. The Company does not produce  
8 effluent water; however it does have the ability to resell effluent water, and for several reasons  
9 believed that it had the exclusive right to sell effluent water in its service territory. Despite a  
10 prior adverse ruling by the Court of Appeals in Arizona on this very issue in 1991, the  
11 Company unsuccessfully litigated this issue with the City all the way through both state and  
12 federal appeals courts from 1992 to 2003. The Company even tried, unsuccessfully, to get a  
13 favorable resolution to this issue with the Commission. In total, the Company expended  
14 \$767,454 in legal fees attempting to get a favorable resolution to an issue that had already  
15 been decided by the Arizona Court of Appeals in 1991<sup>3</sup>. Ratepayers should not have to pay  
16 for unnecessary and overzealous litigation. The Commission should deny the Company's  
17 request for its legal expenses.

18 While the litigation itself goes back to 1999, the Company's experience with another  
19 entity's ability to sell effluent water in the Company's service territory dates back to the early  
20 1990s. In *Arizona Water Company v. City of Bisbee*, 172 Ariz. 176, 836 P.2d 389 (App. 1991),  
21 the City of Bisbee ("Bisbee") delivered its effluent water from its sewage plant to Phelps Dodge  
22 Corporation. Id. at 177, 836 P.2d 389, 390. At the time, the Company held a Certificate of

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23 <sup>2</sup> For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of Proceedings.  
24 The transcript page number will identify references to the Transcript.

<sup>3</sup> The issue was decided by the Arizona Court of Appeals in *Arizona Water Company v. City of Bisbee*, 172 Ariz. 176, 836 P.2d 389 on October 24, 1991. The Arizona Supreme Court denied review on September 22, 1992.

1 Convenience and Necessity ("CCN") to provide water service in the service territory where  
2 Phelps Dodge was located. Id. The Company sued Bisbee, demanding that Bisbee cease  
3 providing effluent to Phelps Dodge. Id. The trial Court granted Bisbee's Motion for Summary  
4 Judgment, effectively rejecting the Company's lawsuit. Id.

5 On appeal, the Company claimed that Bisbee's delivery of its effluent water in the  
6 Company's service territory constituted a competing service in violation of A.R.S. §§ 9-515 and  
7 9-516. Id. The Company further claimed that Bisbee's actions were a taking of the Company's  
8 property without just compensation. *Arizona Water Company v. City of Bisbee*, 172 Ariz. 176,  
9 178, 836 P.2d 389, 391. In its Opinion, the Court of Appeals, relying on past precedent and its  
10 interpretation of the relevant statutes, determined that effluent water is not the same as the  
11 ground water that the Company provides its customers. Therefore, concluded the Court, there  
12 was no merit to the Company's claim that Bisbee was competing with the Company. Id.  
13 The Court further reasoned that Bisbee's delivery of effluent was not a taking since the  
14 Company does not own water in Arizona; it only has the right to put it to beneficial use. Id. at  
15 176, 179, 836 P.2d 389, 392 citing *APS v. Long*, 160 Ariz. 429, 773 P.2d 988 (1989). Finally,  
16 the Court rejected the Company's argument that the trial court's ruling violated public policy in  
17 favor of granting regulated monopolies to public service corporations noting that it had already  
18 concluded that Bisbee was not competing with the Company. Id. at 179, 836 P.2d 389, 392. A  
19 Petition for review was denied on September 22, 1992. Id. at 176, 836 P.2d 389.

20 The Company's next opportunity to revisit the issue of its exclusive right to sell effluent  
21 water in its service area came in 1999. The City of Casa Grande ("Casa Grande") filed a  
22 condemnation action against the Company seeking to condemn a portion of the Company's  
23 plant, property and CCN. R-8 at 5. Among other reasons, Casa Grande sued the Company to  
24 acquire the Company's exclusive right to sell water to one of Casa Grande's customers,

1 Reliant Energy, located in the Company's service territory. Id. at 8, 11, 12, 13. Casa Grande's  
2 condemnation action was dismissed on November 15, 1999 on the grounds that Casa Grande  
3 failed to secure an affirmative public vote to bring the action. R-6 at 3. The issue of the  
4 Company's exclusive right to sell effluent water in its service territory was not resolved in Casa  
5 Grande's condemnation action<sup>4</sup>. Id. In total, the Company is requesting ratebase inclusion of  
6 \$314,353 for its legal expenses incurred in the Casa Grande condemnation action. A-21.

7 The issue of the Company's exclusive right to sell effluent water was, however, the  
8 central issue in the Company's lawsuit against Casa Grande filed in District Court on February  
9 25, 2000. In that lawsuit, the Company sought a temporary restraining order and injunctive  
10 relief barring Casa Grande from delivering effluent water to Reliant Energy. R-8. Similar to  
11 *City of Bisbee*, the Company claimed that Casa Grande's delivery of effluent water to Reliant:  
12 1) interferes with the Company's exclusive right to provide water service and is therefore a  
13 competing service and, 2) constitutes a taking of the Company's property without just  
14 compensation. Id. at 7, 8, and 12<sup>5</sup>. The District Court dismissed the Company's lawsuit on  
15 December 21, 2000, on the grounds that the Company failed to exhaust its state remedies in  
16 state court and therefore the District Court does not have jurisdiction over the matter. R- 9.  
17 The Company appealed the District Courts ruling, and the United State Court of Appeals for  
18 the Ninth Circuit affirmed the District Court's ruling on April 1, 2002. R-10. In total, the  
19 Company is requesting ratebase inclusion of \$155,061 for its legal expenses incurred in the  
20 federal court action. A-21.

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22  
23 <sup>4</sup> The Company also sought recovery of its attorney fees related to the condemnation action but was  
unsuccessful. Transcript at 302.

24 <sup>5</sup> Another similarity to the *City of Bisbee* case is that the Company does not produce effluent water in this service  
territory. The Company proposed to resell effluent to Reliant that it purchased elsewhere. Id. at 3-4.

1 Failing to obtain a resolution in District Court, the Company filed essentially the same  
2 action in state court on December 19, 2000. R-11. Again, the Company was asking the Court  
3 to decide the same issues it raised in the *City of Bisbee* case. Id. The Court issued its  
4 Decision on March 27, 2002. The Court, relying primarily on the *City of Bisbee* case, rejected  
5 the Company's arguments. R-13. The Court noted that although the procedural history was  
6 somewhat different, the Company's action presented "essentially the same issues" presented  
7 in the *City of Bisbee* case. Id. at 3. The Court concluded:

8 The *Bisbee* court and the *Long* court both made clear that a city's  
9 provision of effluent to a user in the area covered by a CCN for water is  
not a competing service

10 By the terms of the CCN, AWC has the exclusive right to provide  
water to the users in the area covered by the CCN. Water as the term is  
used in the CCN does not include effluent water. Id. at 5.

11 The Company appealed, arguing that the trial court was wrong, that because of the way  
12 the City of Casa Grande treated its effluent water, it was no longer considered effluent.  
13 Rather, argued the Company, the effluent became "water" in every sense of the word..." R-23  
14 at 4, 5. The appellate court dismissed the Company's argument relying on the *Long* court's  
15 conclusion that treating effluent water does not change it back into groundwater or surface  
16 water. Id at 7. The Court of Appeals went on to say that the *Long* court's response is not only  
17 still appropriate but shall remain appropriate until the Legislature determines otherwise. Id.  
18 Only after such legislation is passed, noted the Court, will the *City of Bisbee* become irrelevant.  
19 Id. at 7-8. In total, the Company is requesting ratebase inclusion of \$263,739 for its legal  
20 expenses incurred in the state court actions. A-21.

21 The Company's attempts to become the exclusive provider of effluent water in the Casa  
22 Grande service territory was not limited to lawsuits in state and federal court. The Company  
23 also sought recourse at the Commission. On May 10, 2000 the Company filed at the  
24

1 Commission proposed Tariff No. RW-256 ("Tariff"). R-14. In its application the Company  
2 proposed to expand effluent service to its service areas where the Company had an  
3 agreement with local treatment facilities to provide the Company with effluent for resale. Id.  
4 On June 1, 2000, Casa Grande requested intervention claiming that the Company was trying  
5 to gain control of, and receive revenue from, the sale of effluent in the Casa Grande service  
6 territory. R- 15 at 1. Staff conducted an investigation and recommended denial of the  
7 proposed Tariff in its report issued on August 8, 2000. R-15, Staff Report at 4. The Company  
8 withdrew its tariff application in November 2000. Transcript at 313.

9 Shortly after Casa Grande intervened in the Company's Tariff application, Casa Grande  
10 filed a complaint at the Commission asserting that the Company's CCN does not apply to  
11 effluent sales. R-16. It appears that Casa Grande did not wish to pursue the matter, and the  
12 docket was administratively closed on February 10, 2004. R-18. In total, the Company is  
13 requesting ratebase inclusion of \$34,301 for its legal expenses incurred in the Complaint filed  
14 by Casa Grande before the Commission. A-21.

15 The Company's request for the ratebase inclusion of \$767,454 for attorney fees related  
16 to its litigation with Casa Grande should be denied. From the outset, it was clear that the law  
17 in Arizona does not consider effluent water as either groundwater or surface water. As the  
18 Court of Appeals made clear, the only way this is going to change is by legislative action. The  
19 Company, however, was determined to try and make the change through the Courts or  
20 through the Commission. The Company was tenacious in its pursuit of this issue through state  
21 and federal courts. When neither of those of those avenues worked, the Company sought  
22 relief with the Commission. The Company chose to pursue the litigation knowing full well the  
23 law in Arizona. The Company's choice was imprudent, unreasonable and resulted in a  
24

1 tremendous waste of its resources. The Commission should not make ratepayers pay for the  
2 poor judgment of the Company.

3 Moreover, the purpose of the litigation was to benefit shareholders, not ratepayers. If  
4 the Company were successful, and allowed to resell effluent to Reliant, ratepayers would not  
5 realize a benefit. To the extent an argument could be made that the Company's customers  
6 would receive a benefit from the reselling of effluent<sup>6</sup>, it is irrelevant to ratepayers. Casa  
7 Grande had the capacity to sell and was already selling its effluent to Reliant. Casa Grande's  
8 taxpayers, who are the same customers of the Company, were already receiving whatever  
9 benefit could possibly be claimed on behalf of ratepayers. Substituting the Company as  
10 provider of the service provides no greater benefit to ratepayers than they were already  
11 getting. The benefit, of course, inures to the shareholders in the form of higher returns.

12 In this situation, the ratepayer/taxpayer relationship works against ratepayers. Casa  
13 Grande, like the Company, also incurred significant expenses prosecuting and defending the  
14 litigation. Casa Grande residents, who make up approximately 80 percent of the Company's  
15 customers, paid for Casa Grande's legal expenses through taxes. Transcript at 400, 936 –  
16 937. Taxpayers should not have to pay for the legal expenses again through their water bills.

17 The Commission will be sending out the wrong message if it requires ratepayers to pay  
18 for the Company's legal expense in this instance. Companies should not be encouraged to  
19 engage in litigation. Litigation should be a last resort and used only when absolutely  
20 necessary. Here, the Company's reliance on litigation was reckless, and arguably negligent.  
21 The Commission should provide a disincentive for this type of conduct in the future. The  
22 Commission should not make ratepayers pay for the Company's legal expense.

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24 <sup>6</sup> No party has shown how ratepayers would benefit from the Company's ability to resell effluent.

1 Perhaps the most egregious aspect concerning the legal expenses is the Company's  
2 recommended accounting treatment. The Company has booked the Casa Grande legal  
3 expenses in a non-depreciable account. R-31 at 16. This means that absent future  
4 Commission action, there will never be a decrease in the legal expense figure and the  
5 Company will continue to earn a return on these expenses in perpetuity. Id. In other words, at  
6 the Company's recommended rate of return, the Company will have earned the whole  
7 \$764,454 in pretax operating income in approximately nine and a half years. Transcript at 589.  
8 After that, additional earnings on the legal fees would be icing on the cake. Given the  
9 circumstances of the litigation, this result is not only unfair it is punitive to ratepayers and  
10 should be rejected by the Commission.

## 11

### 12 2) DEFERRED CAP

13 The Company is seeking recovery of its deferred CAP ("CAP") charges associated with  
14 its Casa Grande, Coolidge and White Tank Systems. The Company is requesting that it be  
15 permitted to amortize and recover the CAP charges over a ten-year period and be able to treat  
16 all future CAP charges as a regular operating expense. R-30 at 16. RUCO opposes the  
17 Company's request, except as it pertains to those Casa Grande customers who are receiving  
18 and paying for non-potable CAP water<sup>7</sup>.

19 The Company's CAP allocations are non-used and useful at this time<sup>8</sup>. As a general  
20 ratemaking principle, investments which are not used and useful during the test year are  
21 excluded from rates. Id. The obvious reason for the exclusion is that ratepayers should not

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22  
23 <sup>7</sup> Those customers use approximately 30% of the Company's Casa Grande CAP allocation. R-30 at 17.

24 <sup>8</sup> With the exception of the Casa Grande customers described above. The rest of this discussion will only address that portion of the Company's CAP allocation that is not being used.

1 have to pay for investments from which they derive no benefit. Id. The Commission has  
2 historically followed this rule as it applies to deferred CAP charges. Id. at 19. There is nothing  
3 unusual about this case nor is there anything which distinguishes<sup>9</sup> it from other cases that the  
4 Commission has decided. The Commission should deny the Company's request because the  
5 CAP charges are not used and useful.

6 It is also very likely that the inclusion of CAP charges will result in intergenerational  
7 inequities. Id. at 19-20. In other words, if the CAP charges are approved, it is possible that  
8 some ratepayers will end up paying for CAP water that they will receive no benefit from. Id. at  
9 19. Given a ten to fifteen year projected build out for CAP treatment facilities, it is highly likely  
10 that some ratepayers will have left the service area prior to build out. Clearly, intergenerational  
11 inequities is one of the reasons why the Commission should continue to adhere to the used  
12 and useful principle and reject the Company's request.

13 RUCO is aware of and sensitive to the fact that significant deferral charges have  
14 accumulated to date. RUCO supports the proposal made by Staff to address the CAP issue in  
15 this case. Transcript at 103. RUCO's support, however, should not be interpreted to change  
16 its position as set forth above. RUCO believes that Staff's proposal is a clean solution to the  
17 issue in this case and should not be considered to have any precedential effect.

### 18 19 **3) WORKING CAPITAL**

20 The issue here is the proper calculation of the Company's income tax lag. The  
21 Company's calculation of its federal and state income tax lag assumes that the Company  
22 makes monthly payments to the Internal Revenue Service ("IRS") and the Arizona Department  
23

24 <sup>9</sup> The other cases referenced in this proceeding where deferred CAP charges were at issue included the  
Company's Eastern Division case, Decision No. 66849 and the Vail Water case, Decision No. 62450.

1 of Revenue ("ADOR"). A-11 at 11. The Company translates this into lag factors of 2.52 days  
2 for federal income tax purposes and 27.05 days for State Income tax purposes. The  
3 Commission adopted this methodology in the Company's Northern and Eastern Group cases.

4 Staff, which agreed with the Company's methodology in the Eastern Division case,  
5 admits that it made a mistake in the Eastern Division case and that Staff and ultimately the  
6 Commission used an incorrect lag date calculation in that case. Transcript at 1242 – 1243.  
7 Staff came to that realization after it did some more research based on RUCO's arguments in  
8 the Eastern Division case. Id. Staff concluded that the income tax lead-lag should be  
9 calculated based on when payments are actually paid, which for state and federal taxes is  
10 quarterly. S-32 at 4. Using quarterly payments, Staff calculated 37 days as the appropriate  
11 number of lag days for both state and federal income tax. Id

12 RUCO, like Staff, based its lead/lag day calculation on quarterly income tax payments.  
13 RUCO's lead/lag study, however, compared the lead/lag days either authorized or requested  
14 by four of the largest utilities in Arizona – APS, Qwest, TEP, and Southwest Gas. R-29 at 4,  
15 R-24. Since a lead/lag study is based on the Company's service period, and service period is  
16 the same for all the utilities as well as all customer classes, RUCO's lead/lag comparison to  
17 other utilities is an apple to apple comparison and provides the best and most accurate way to  
18 measure lead/lag days. Transcript at 971 – 972. By comparison, RUCO's recommended lag  
19 days of 61.95 for federal income tax and 99.80 for state income tax is much closer to the  
20 lead/lag days of the utilities used in RUCO's sample. R-29 at 4. The Commission should  
21 reject the Company's recommended lead/lag days.

22 Cash working capital is designed to allow the Company available cash on hand to  
23 cover the difference in time period from when revenues are received and expenses are paid.  
24 Transcript at 975. The Company pays income taxes quarterly. The Company's 2.52 lag day

1 calculation equates to a weekly payment period. Transcript at 987. The Company's  
2 calculation of 2.52 lag days for federal taxes and 27.05 lag days for state taxes is ridiculous  
3 and should be rejected.

## 4 5 **OPERATING INCOME**

### 6 **1) REVENUE ANNUALIZATION**

7 It is an accepted ratemaking principle to annualize revenues to the test year end. No  
8 party disputes this principle. Revenue annualization is measured by the Company's growth  
9 during the test-year. RUCO measures the growth by calculating the difference between the  
10 Company's number of customer at the beginning of the test-year and the number of customers  
11 at the end of the test-year. In this case the difference was 1,257 customers.

12 The Company believes that the proper way to measure test year growth is to take the  
13 difference between the test year average number of customers and the actual year end  
14 number of customers. Transcript at 760. In this case, the difference between the average and  
15 the ending number of customers is 670. Transcript at 761. The effect of using a smaller  
16 number to represent growth would be to lower the Company's revenues as well as the  
17 expenses. Transcript at 989.

18 The Company's measurement of test-year growth only accounts for approximately six  
19 months of test-year growth. Transcript at 989. It does not make sense to measure a year's  
20 worth of growth by crediting only six months of growth. The Company's recommendation does  
21 not make sense and has only one purpose, to understate its revenues and expenses. The best  
22 and most accurate measure of the Company's growth in the test year is by the number of new  
23 customers. The Commission should reject the Company's methodology for annualizing its  
24 revenues.

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2           **2)     PURCHASED POWER EXPENSE**

3           RUCO recommends upward adjustments to the Company's recommended purchase  
4 power expense for all five Western group divisions. R-30 at 27. Transcript at 1035-1036.  
5 RUCO's recommendation is based on the recent increase in rates granted by the Commission  
6 in the APS rate case, and RUCO's recommended elimination of the purchased power  
7 adjustment mechanism. R-30 at 27.

8           RUCO also became aware, after the Company filed its Rebuttal testimony, that the  
9 Company was actually paying APS a higher rate under one of its tariffs than RUCO initially  
10 understood. Specifically, the rate increase under APS' tariff E-221 was actually five percent,  
11 not three and one-half percent as RUCO initially understood. Transcript at 1034-1035. RUCO  
12 made the changes and is recommending upward adjustments of \$264 for the Stanfield system,  
13 \$4,983 for the Casa Grande system, \$4 for the Ajo system, \$747 for the Coolidge system and  
14 \$396 for the White Tank system. Id. at 1036. The Commission should adopt RUCO's  
15 adjustments to the Company's recommended purchased power expenses.

16  
17           **3)     PROPERTY TAXES**

18           RUCO's recommended property tax expense calculation was based on the Arizona  
19 Department of Revenue's ("ADOR") property tax formula. R-28 at 21. The property tax  
20 formula, as prescribed in ADOR's memo to the Company dated January 3, 2001, values water  
21 utilities, for property tax purposes, by multiplying the average of the water utility's three  
22 previous years of reported gross revenues by a factor of two. Id.

23           The Company has disregarded the revenues required under the ADOR directive and  
24 substituted in its place the adjusted test year revenues twice and its proposed level of

1 revenues once ("Company methodology"). Id. RUCO, for valuation purposes, has included the  
2 test year (2003) and the prior two years (2001, 2002) as directed by ADOR, and doubles that  
3 average ("ADOR methodology"). The Company argues that the use of the revenues required  
4 under the ADOR methodology does not take into consideration the increased revenues that  
5 will be approved by the Commission in this proceeding. A-11 at 25, A-12 at 10. The  
6 Company's argument is wrong. The ADOR methodology does take into consideration future  
7 rate increases. The ADOR formula inherently projects an increase in the operating revenues  
8 by doubling the three-year historical average of operating revenues. Transcript at 1020. The  
9 Company's methodology doubles adjusted and projected revenues, which overstates the tax  
10 expense.

11 Further, the Company's methodology does not consider the time lag of when the  
12 proposed revenues in this case by the Company will be realized, when those revenues will be  
13 recognized in the ADOR formula, and when property taxes based on those revenues will be  
14 paid. Assuming an Order in this case is issued at the end of 2005, a full year of the proposed  
15 revenues will not be realized by the Company until the end of 2006. ADOR will not use the  
16 proposed revenues for property taxes until 2007, and the Company will not actually have to  
17 pay these taxes until October 2007 and March 2008. The test year in this case is 2003;  
18 however, the Company's methodology generates a level of expense that will not be incurred  
19 until 2008. The Commission should adopt the ADOR methodology.

1 **PURCHASED WATER AND PURCHASE POWER ADJUSTMENT MECHANISMS**

2 **THE CIRCUMSTANCES IN THIS CASE DO NOT SUPPORT THE CONTINUATION OF**  
3 **THE COMPANY'S PURCHASED WATER AND PURCHASE POWER ADJUSTOR**  
4 **MECHANISMS**

5 RUCO recommends that the Commission deny the Company's request to continue the  
6 automatic adjustors for purchased water and purchased power expenses. The Commission,  
7 for the very reasons it did in the Company's Eastern Division case, should deny the  
8 Company's request for a purchased water ("PWAM") and purchase power adjustor mechanism  
9 ("PPAM").

10 In the Company's Eastern Division case, the Company recommended that the  
11 Commission continue both its PPAM and PWAM. The Commission rejected the Company's  
12 request, noting that adjustment mechanisms provide a disincentive for the Company to obtain  
13 the lowest possible cost commodity because the costs are simply passed through to  
14 ratepayers. Furthermore, the Commission determined the record did not support the  
15 Company's contention that purchased power costs were a significant portion of the Company's  
16 expenses, or were particularly volatile. S-1 at 13-14. The Company's water purchases were  
17 only a small percentage of one of its division's total water purchases, and the evidence did not  
18 support that another division was likely to incur significant increases or decreases in its  
19 purchased water costs. Id. at 14.

20 The circumstances in the Eastern division case parallel the circumstances in this case.  
21 Staff has broken down the purchased power expenses by each of the five systems in the  
22 Western group and compared them as a percent of total operating expenses. S-10 at 8. By  
23 comparison, purchased power expenses represent .1202% of Casa Grande's total expenses;  
24 .16556% of Stanfield's total; .0078% of Ajo's total; .0734% of Coolidge's total; and .1184% of  
White Tank's total. It is clear that purchased power does not represent a significant portion of

1 each system's total operating expense. Id. The Commission should discontinue both the  
2 PPAM and PWAM.

3           The Company's purchased power expenses do not fluctuate widely. Under  
4 cross-examination, the Company admitted that it has experienced "steady" decreases over the  
5 past five to eight years. Transcript at 583. Historically, APS tends to maintain stable rates,  
6 and is inclined to reduce volatility by planning rate changes through gradual incremental steps.  
7 In APS' recent rate case, the Commission approved an adjustor mechanism subject to a cap,  
8 assuring until at least the next rate case that rates will not be fluctuating widely. The evidence  
9 does not support the Company's argument that it's purchased power expenses will be volatile  
10 or fluctuate greatly in the future. The Commission should reject the Company's request for a  
11 PWAM.

12           Likewise, the cost of water to the Ajo<sup>10</sup> system, while large, is not volatile, nor does it  
13 fluctuate greatly. S-10 at 9. Automatic adjustors should be used in very limited circumstances  
14 and not as a substitute for a rate case, or as an opportunity to practice single-issue  
15 ratemaking. As in the Eastern case, those circumstances are not present, and the  
16 Commission should deny the Company's request to continue its PPAM and PWAM.

## 17 18 **RATE DESIGN**

19           RUCO's recommended rate design implements a two tier inverted block rate structure.  
20 R-28 at 24. RUCO's rate design implements a break over point at the 4000 gallon level.  
21 RUCO's breakover point is approximately 6,095 gallons below the average level of  
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24 <sup>10</sup> Ajo is the only division in the Company's western group that has a PWAM. Id.

1 consumption for the 5/8 X 3/4-inch meter sizes for all five systems. R-28 at 26. RUCO  
2 believes that setting the break point at this level will ensure that customers on each of the five  
3 systems will experience a price signal as their consumption rises. Id. Arguably, the potential  
4 to promote conservation is better motivated by a higher usage charge beyond what is average,  
5 rather than allowing a larger user a lower rate. RUCO's proposed rate design does not  
6 discriminate between class or meter size. It is a fair rate design because, stated simply, each  
7 customer pays the same commodity rate for the same level of usage.

### 8 9 **COST OF CAPITAL**

10 RUCO believes that the Commission should adopt RUCO's recommended rate of return  
11 of 9.17 percent, which is the weighted cost of RUCO's recommended costs of debt and equity  
12 capital. R-4 at 5.

13 RUCO believes that the recommended 9.44 percent cost of common equity is  
14 appropriate given the current environment of low inflation and low interest rates. RUCO further  
15 believes that the 9.44 percent cost of common equity estimated by RUCO witness William A.  
16 Rigsby is very reasonable when the Company's capital structure of 73 percent common equity  
17 and 27 percent debt is compared with the capital structures of publicly traded water providers  
18 which averaged 56 percent equity and 44 percent debt. Id. at 41-42. Despite the fact that  
19 Arizona Water Company's capital structure is much richer in equity than the average capital  
20 structure of the water providers included in his analysis, Mr. Rigsby has made no downward  
21 adjustment to the results that he obtained in his DCF model. Id. at 27-28. Furthermore, Mr.  
22 Rigsby's discounted cash flow growth rate estimate of 6.50 percent exceeds the estimates of  
23 independent analysts by 50 to 61 basis points. Id. at 20. Finally, despite the position taken by  
24 the Company's cost of capital consultant, Dr. Zepp, Mr. Rigsby's recommended 9.44 percent  
cost of common equity was derived from a DCF model that assumes that if regulation performs

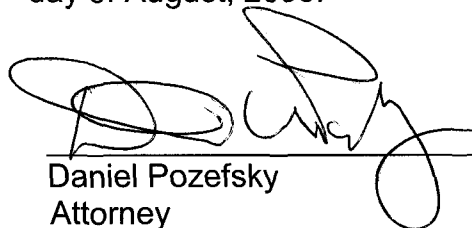
adequately, the book and market value of a utility's stock will be driven toward equality if the utility's rate of return is set at or near it's cost of capital. Id. at 15. The Commission should adopt RUCO's recommended rate of return of 9.17 percent.

## CONCLUSION

RUCO recommends that the Arizona Corporation Commission ("Commission") approve a total revenue increase of no more than \$138,057. RUCO also recommends the Commission deny: the Company's request for \$767,454 in capitalized legal expenses related to the Company's litigation with the City of Casa Grande; the Company recovery of deferred CAP charges associated with the Western Group systems; the Company's requested level of cash working capital; and the Company's request for the continuation of automatic adjustors for purchased water and purchased power.

RUCO further recommends the Commission adopt RUCO's recommended test-year revenue and expense annualization based on the level of customer growth for the entire test-year; RUCO's adjustment for purchased power expense and property tax expense based on the formula used by the Arizona Department of Revenue; RUCO's proposed three-tier inverted block structure; and finally RUCO's 9.17% weighted average cost of capital.

RESPECTFULLY SUBMITTED this 1<sup>st</sup> day of August, 2005.

  
Daniel Pozefsky  
Attorney

## EXHIBIT 1

ARIZONA WATER COMPANY  
TEST YEAR ENDED DECEMBER 31, 2003  
WESTERN GROUP  
REVISED REVENUE SUMMARY COMPARISON

LINE NO.	DESCRIPTION	AJO HEIGHTS RUCO REVISED	CASA GRANDE RUCO REVISED	COOLIDGE RUCO REVISED	STANFIELD RUCO REVISED	WHITE TANK RUCO REVISED	WESTERN GROUP RUCO REVISED
1	ADJUSTED RATE BASE	\$ 847,736	\$ 17,495,427	\$ 2,738,654	\$ 316,811	\$ 1,904,074	\$ 23,302,701
2	ADJUSTED OPERATING INCOME	37,858	1,582,271	230,982	29,258	181,343	2,061,712
3	CURRENT RATE OF RETURN (L2 / L1)	4.47%	9.04%	8.43%	9.24%	9.52%	8.85%
4	REQUIRED RATE OF RETURN	9.17%	9.17%	9.17%	9.17%	9.17%	9.17%
5	REQUIRED OPERATING INCOME (L4 * L1)	77,737	1,604,331	251,135	29,052	174,604	2,136,858
6	OPERATING INCOME DEFICIENCY (L5 - L2)	39,879	22,060	20,153	(207)	(6,739)	75,145
7	GROSS REVENUE CONVERSION FACTOR	1.31441	1.63249	1.61031	1.26758	1.54186	1.46687
8	GROSS REVENUE INCREASE	<u>\$ 52,418</u>	<u>\$ 36,012</u>	<u>\$ 32,452</u>	<u>\$ (262)</u>	<u>\$ (10,391)</u>	<u>\$ 110,229</u>
9	CURRENT REVENUES T/Y ADJUSTED	404,072	7,366,204	1,358,121	116,474	758,382	10,003,254
10	PROPOSED ANNUAL REVENUE (L8 + L9)	456,490	7,402,216	1,390,574	116,212	747,991	10,113,483
11	PERCENTAGE AVERAGE INCREASE	12.97%	0.49%	2.39%	-0.23%	-1.37%	1.10%

ARIZONA WATER COMPANY  
TEST YEAR ENDED DECEMBER 31, 2003  
AJO SYSTEM  
REVISED RATE BASE - ORIGINAL COST

LINE NO.	DESCRIPTION	AJO HEIGHTS RUCO REVISED	CASA GRANDE RUCO REVISED	COOLIDGE RUCO REVISED	STANFIELD RUCO REVISED	WHITE TANK RUCO REVISED	WESTERN GROUP RUCO REVISED
1	PLANT IN SERVICE	\$ 1,656,478	\$ 47,262,942	\$6,083,129	\$ 602,560	\$ 5,580,520	\$ 61,185,629
2	PHOENIX OFFICE & METER SHOP ALLOCATION	43,498	947,818	201,010	14,195	90,661	1,297,182
3	DEFERRED CAP CHARGES	-	-	-	-	-	-
4	ACCUMULATED DEPRECIATION	(624,244)	(12,072,217)	(2,271,697)	(195,716)	(1,088,906)	(16,252,780)
5	NET PLANT IN SERVICE	\$ 1,075,732	\$ 36,138,543	\$4,012,442	\$ 421,038	\$ 4,582,275	\$ 46,230,030
6	CONSTRUCTION WORK IN PROGRESS (CWIP)	-	-	-	-	-	-
7	TOTAL NET PLANT	\$ 1,075,732	\$ 36,138,543	\$4,012,442	\$ 421,038	\$ 4,582,275	\$ 46,230,030
8	ADVANCES IN AID OF CONSTRUCTION (AIAC)	(36,395)	(8,891,444)	(406,644)	-	(1,887,880)	(11,222,363)
9	CONTRIBUTIONS IN AID OF CONSTRUCTION (CIAC)	(41,263)	(7,754,812)	(437,102)	(49,164)	(554,839)	(8,837,180)
10	ACCUMULATED AMORTIZATION OF CIAC	10,797	1,348,820	74,970	7,813	111,896	1,554,296
11	DEFERRED INCOME TAXES	(157,495)	(3,387,966)	(504,369)	(62,528)	(352,670)	(4,465,028)
12	WORKING CAPITAL	(3,640)	42,286	(643)	(349)	5,292	42,945
13	TOTAL RATE BASE	<u>\$ 847,736</u>	<u>\$ 17,495,427</u>	<u>\$2,738,654</u>	<u>\$ 316,811</u>	<u>\$ 1,904,074</u>	<u>\$ 23,302,701</u>

ARIZONA WATER COMPANY  
TEST YEAR ENDED DECEMBER 31, 2003  
CASA GRANDE SYSTEM  
REVISED RECOMMENDED OPERATING INCOME

LINE NO.	DESCRIPTION	AJO HEIGHTS RUCO REVISED	CASA GRANDE RUCO REVISED	COOLIDGE RUCO REVISED	STANFIELD RUCO REVISED	WHITE TANK RUCO REVISED	WESTERN GROUP RUCO REVISED
<u>REVENUES - WATER:</u>							
1	REVENUE FROM WATER SALES	\$ 456,490	\$ 7,402,216	\$ 1,390,574	\$ 116,212	\$ 747,991	\$ 10,113,483
2	OTHER REVENUES	2,944	622,917	64,236	15,802	21,953	727,852
3	TOTAL OPERATING REVENUES	\$ 459,434	\$ 8,025,133	\$ 1,454,810	\$ 132,014	\$ 769,944	\$ 10,841,335
<u>OPERATING EXPENSES:</u>							
4	PURCHASED WATER	\$ 162,114	\$ 338,564	\$ -	\$ -	\$ 10,279	\$ 510,957
5	OTHER	91	58,284	7,371	651	2,470	68,865
6	PURCHASED POWER	2,986	827,240	99,244	18,282	81,544	1,029,296
7	PURCHASED GAS	-	-	603	-	-	603
8	OTHER	12,586	278,354	37,807	4,118	26,486	359,351
9	WATER TREATMENT	3,391	190,237	13,176	453	9,609	216,867
10	TRANSMISSION & DISTRIBUTION	38,893	755,729	195,760	12,183	75,967	1,078,532
11	CUSTOMER ACCOUNTS	27,288	602,122	190,344	8,687	54,668	883,109
12	SALES	142	2,962	259	44	263	3,670
13	ADMINISTRATIVE & GENERAL	45,617	952,718	235,586	14,451	87,371	1,335,743
14	DEPRECIATION & AMORTIZATION	39,981	1,015,427	170,521	24,713	131,999	1,382,640
15	PROPERTY TAXES	26,452	560,835	113,345	12,424	37,146	750,202
16	OTHER TAXES	3,759	76,751	24,577	1,154	6,608	112,849
17	FEDERAL INCOME TAXES	13,023	624,106	93,850	3,870	56,802	791,652
18	STATE INCOME TAXES	5,373	137,474	21,232	1,933	14,128	180,141
19	TOTAL OPERATING EXPENSES	<u>\$ 381,697</u>	<u>\$ 6,420,802</u>	<u>\$ 1,203,675</u>	<u>\$ 102,962</u>	<u>\$ 595,340</u>	<u>\$ 8,704,477</u>
20	NET INCOME	<u>\$ 77,737</u>	<u>\$ 1,604,331</u>	<u>\$ 251,135</u>	<u>\$ 29,052</u>	<u>\$ 174,604</u>	<u>\$ 2,136,858</u>

1 AN ORIGINAL AND THIRTEEN COPIES  
2 of the foregoing filed this 1st day  
3 of August, 2005 with:

3 Docket Control  
4 Arizona Corporation Commission  
5 1200 West Washington  
6 Phoenix, Arizona 85007

6 COPIES of the foregoing hand delivered/  
7 mailed this 1st day of August, 2005 to:

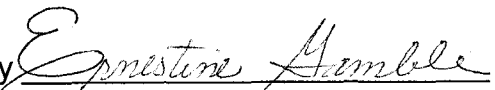
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